BEACON RESEARCH

Consultation Paper on providing flexibility to Alternative Investment Funds (AIFs), Venture Capital Funds (VCFs) and their investors to deal with unliquidated investments of their schemes beyond expiry of tenure.

January 12, 2024

Background

AIF Regulations amended on June 15, 2023, to provide Flexibility to AIFs in handling unsold investments from their 'Original Scheme' during winding up, by either selling such investments to a new scheme of the same AIF ('Liquidation Scheme') or distribute in-kind to investors. SEBI requires AIFs to adhere to specified norms for recognizing the value of investments sold to the Liquidation Scheme, ensuring accurate disclosure of asset quality and fund performance. Operational details for launching the Liquidation Scheme were outlined in the SEBI Circular dated June 21, 2023 (Annexure A) The Liquidation Scheme option is currently open only to AIF schemes within the 'Liquidation Period,' spanning one year after the scheme's tenure or extended tenure for complete liquidation.

Brief

A. Providing flexibility to AIFs to deal with unliquidated investments within the same scheme of AIF instead of the requirement of launching new scheme ('Liquidation Scheme')

Background

SEBI has received concerns from the AIF industry regarding the launch of a Liquidation Scheme and selling unliquidated investments to it. Issues include the time, cost, and efforts involved in setting up and managing the Liquidation Scheme, impacting investors. Tax-related challenges arise due to asset transfer and unit replacement. To address this, there's a proposal to explore extending the existing scheme beyond its tenure for a specific Dissolution Period to fully liquidate unliquidated investments. However, ensuring this flexibility doesn't compromise the core regulatory principles of asset quality, liquidity, and performance by AIFs to ensure integrity and trust in the AIF ecosystem.

Proposal A

AIF Regulations may be suitably amended to allow AIF schemes to undergo a Dissolution Period/Process for handling unliquidated investments after tenure completion, eliminating the need for a separate liquidation scheme. This modification aims to ensure accurate recognition and disclosure of asset quality and fund performance.

The proposed framework in this regard is as under

1. AIF needs 75% investor consent if AIF decides to opt for Dissolution Period/Process during Liquidation Period of scheme.

2. Upon obtaining the consent, AIF shall arrange bids for 25% of unliquidated investments value. The bids arranged shall represent the consolidated value of all unliquidated investments.

3. Investor approval and bids shall be obtained before the Liquidation Period ends and AIFs shall also intimate to SEBI about investor approval and the decision to enter Dissolution Process

4. Bid value and valuations conducted by two independent valuers shall be disclosed to all investors before the Liquidation Period expires.

5. Dissenting investors shall be offered an **option to exit from 25% bid**. After exercising the exit option by dissenting investors, any Unsubscribed portion may be used for pro-rata exit to non-dissenting investors.

6. Bidders or its related parties who are investors in the scheme cannot exit from the scheme out of the bid.

7. For appropriately recording in the track record of the manager and for reporting to Performance Benchmarking Agencies, the value of such unliquidated investments of the scheme shall be.
    - **Bid value**, if the AIF/ manager arranges a bid for a minimum of 25% of the value of unliquidated investments of the scheme.
    - **One Rupee**, if the AIF/ manager fails to arrange a bid for a minimum of 25% of the value of unliquidated investments of the scheme.

8. Dissolution Period/Process begins after Liquidation Period expiry and shall not be more than the original scheme tenure.

9. Extension of the Dissolution Process is not permitted, and if the AIF scheme fails to sell unliquidated investments within this period, mandatory in-specie distribution to investors ensues.

10. No new commitments or investments are accepted during the Dissolution period/process and no management fee shall be charged during the Dissolution period/process.

11. Moreover, scheme performance shall not be reported to Performance Benchmarking Agencies and cannot be used in marketing documents to solicit funds from future investors.

B. **One-time flexibility to schemes of AIFs, whose Liquidation Period has expired to deal with unliquidated investments.**

Background

The option to launch a Liquidation Scheme is currently unavailable for AIF schemes whose Liquidation Period ended before June 15, 2023, Some AIF schemes, with tenures and liquidation periods ending before June 15, 2023, haven't wound up and still hold unliquidated investments. Responding to requests from the AIF industry, SEBI is considering allowing flexibility for these schemes. This involves extending the Dissolution Period/Process framework, subject to approval from at least 75% of investors by the value of their investment in the scheme. The aim is to address operational challenges in dealing with unliquidated investments and safeguard the interests of investors.

Proposal B

Schemes of AIFs whose Liquidation Period has already expired or would be expiring within one month from the date of notification in this regard, and do not have any pending investor complaint with respect to non-receipt of funds/investments, will get a fresh one-time Liquidation Period which shall begin from the date of notification of the amendment to AIF Regulations in this regard. During the Liquidation Period, these AIFs shall either fully liquidate their investments or distribute their investments in-specie or opt for the Dissolution Period/Process.

C. Extending flexibility of Dissolution Period/Process to VCFs through migration to AIF regime

Background

The VCF Regulations, established on December 04, 1996, aimed to support early-stage companies in India. However, the AIF Regulations, enacted on May 21, 2012, replaced VCF Regulations, governing various pooled investment vehicles. Under AIF Regulations, VCFs are allowed to operate until their existing fund or scheme is wound up, with constraints on launching new schemes or increasing corpus. VCFs also have the option to seek re-registration under AIF Regulations with 2/3rd investor approval. While AIF Regulations mandate surrendering registration upon winding up, VCF Regulations lack this requirement. As of June 30, 2023, only 49 out of 179 registered VCFs submitted quarterly reports, signaling potential winding up, non-operation, or reporting defaults for the remaining VCFs.

VCF Regulations mandate disclosing the fund's maturity period in the Private Placement Memorandum (PPM) and require winding up of schemes when the stated period expires. The lack of guidelines for surrendering registration certificates after scheme winding up has led to non-compliance. SEBI received requests for VCF tenure extensions, with instances of extensions up to 5 years beyond PPM disclosures. To address this, AIF Regulations offer VCFs the option to seek re-registration, contingent on the approval of 2/3rd of their investors by value. However, operational challenges have hindered widespread adoption of this option. Consequently, there's a perceived need for a new framework facilitating the migration of VCFs to AIF Regulations. Migration principles focus on a streamlined process, preserving key flexibilities for Migrated VCFs, extending selected benefits, and implementing relevant AIF Regulations' provisions. Additionally, regularization considerations are offered for non-compliant VCFs operating beyond the Liquidation Period if they opt for Dissolution Period/Process through migration under AIF Regulations.

Proposal C

The proposed regulatory framework for migration of VCFs to AIF Regulations, is as under

1. AIF Regulations introduce "Migrated VCFs" as a sub-category under Category I – VCFs, requiring existing VCFs to migrate within 6 months of SEBI's notification and adopt the designation of Category I AIF – VCF (Migrated VCFs).

2. VCFs won't incur application, registration, or migration fees. To migrate, VCFs submit their original registration certificate to SEBI. Upon verification, SEBI issues a new "Category I AIF – (Migrated VCF)" certificate without surrendering the VCF registration. VCFs, already SEBI-registered, won't face additional AIF eligibility criteria, streamlining the migration process.

3. Certain flexibility under VCF Regulations may continue to be availed by Migrated VCFs to ensure no adverse impact on investment activities. To ensure smooth investment activities, Migrated VCFs can retain certain flexibilities from VCF Regulations, exempting them from specific AIF Regulations requirements, including minimum investment, corpus size, continuing interest, maximum investors, and allowing flexibility in calculating tenure per the respective PPM. Audit of PPM terms is also excluded.

4. Migrated VCFs may have the option to choose the Dissolution Period/Process during the Liquidation Period for handling unliquidated investments.

5. To ensure that Migrated VCFs do not extend their tenure indefinitely and that investors in Migrated VCFs have a definite investment horizon, the following may be specified w.r.t. tenure of Migrated VCF
   a. Migrated VCFs' tenure equals the residual period disclosed in the PPM under VCF Regulations. If no definite tenure is specified, it will be defined at migration with 75% investor approval.
   b. Migrated VCFs can extend tenure up to two years from the end of the existing definite tenure, subject to 2/3rd unit holder consent.
   c. For Migrated VCFs with an expired or expiring Liquidation Period (within one month of the amendment) a one-time Liquidation Period is granted for a year from fresh SEBI registration. During this, they must sell the unliquidated investments or opt for Dissolution, with at least 75% investor approval or distribute such investments in-specie to the investors.

6. For effective regulatory oversight, Migrated VCFs must adhere to specific AIF Regulations
   - Code of Conduct for Fund, manager, key personnel, and trustee
   - Manager's responsibilities for all Fund decisions
   - If an Investment Committee exists, rules for its constitution and responsibilities.
   - Detailed policies for compliance with regulations, placement memorandum, agreements, and laws.
   - Notification of material changes from the application details
   - SEBI approval for Sponsor or Manager change, with associated fees and conditions
   - Regulations on advisory services by Manager to investors
   - Segregation of assets/liabilities and dedicated accounts for Fund schemes
   - Manager and Sponsor duties regarding Conflict of Interest, Transparency, Dispute Resolution, and Record Maintenance
   - Reporting performance to benchmarking agencies.
   - Valuation of investment portfolios with necessary modifications

7. Applicability of circulars under AIF Regulations to Migrated VCFs is placed at Annexure B

8. VCFs opting to migrate before the expiration of their Liquidation Period are granted flexibility for tenure extension and the option to choose the Dissolution Period/Process. Those choosing not to migrate will face additional reporting requirements similar to AIF Regulations and are ineligible for tenure extension or opting for the Dissolution Period/Process. VCFs operating beyond the Liquidation Period in non-compliance with VCF Regulations may be considered for regularization upon migration to AIF Regulations and selecting the Dissolution Period/Process. However, VCFs whose Liquidation Period has expired and opt not to migrate will be subject to appropriate regulatory action for exceeding the original Liquidation Period. Inactive VCFs, including those not initiating investment activity and those having wound up schemes but not surrendered their registration certificate, will have their certificates canceled under VCF Regulations.

Notes

- Please provide public comments on the attached format as outlined in the consultation paper dated January 12, 2024, by the latest February 02, 2024.
- For details regarding Annexure B on the Applicability of Circulars under AIF Regulations to Migrated VCFs, refer to the consultation paper dated January 12, 2024.
- For details regarding Annexure A on modalities of launching a Liquidation Scheme, refer to the consultation paper dated January 12, 2024.

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